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No. 90-986

IN THE
Supreme Court of the United States
OCTOBER TERM, 1990

ARMCO EXPORT SALES CORPORATION, *et al.*,
Petitioners,
v.
COMPTROLLER OF THE TREASURY,
Respondent.

Petition for a Writ of Certiorari to the Court of Special Appeals of Maryland

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BRIEF IN OPPOSITION

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QUESTION PRESENTED

Does a State have nexus to impose a fairly apportioned income tax on export profits when the exported goods are manufactured in the taxing state by a parent company, and all of the activity to earn the income is performed by the parent company of the wholly owned subsidiary that is taxed?

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BRIEF IN OPPOSITION

Comptroller of the Treasury of the State of Maryland, Respondent, for reasons detailed herein, urges the Court to deny issuance of a Writ of Certiorari to the Court of Special Appeals of Maryland to review the judgment in *Comptroller of the Treasury v. Armco Export Sales Corporation*, et al., 82 Md. App. 429, 572 A. 2d 562 (1990).

STATEMENT OF THE CASE

Each of the Petitioners herein is a Domestic International Sales Corporation ("DISC") authorized under I.R.C. § 991 et seq. A DISC is a tax shelter subsidiary permitted to operate as a phantom corporation; its sole function is to book profits on export sales that are actually made by the parent company. A DISC will typically have no tangible property or employees of its own; all transactions that yield income nominally earned by the DISC are conducted by and in the name of the parent company.

Thus, when the parent company manufactures a widget and then sells it to a non-U.S. buyer the sole function of the DISC is to record in a separate corporate entity the profit on that sale, the precise amount of which is determined under the Internal Revenue Code.

Each Petitioner herein fits this pattern. Each one was a subsidiary of a large multinational parent company that had manufacturing facilities in Maryland from which a concededly unitary business was conducted; each one manufactured products in Maryland that were exported so as to yield DISC income. Each Petitioner functioned solely as a bookkeeping entity that had no independent existence of its own; each one "earned" profits pursuant to agreements with its parent company that entitled the DISC to a profit every time a qualifying export sale conducted by and in the name of the parent company occurred.

The one exception to this general rule concerned a practice of one of the Petitioners, Thiokol International, Inc. ("Thiokol"). Rather than keeping all records for the DISC at corporate headquarters (which was different from the state of DISC incorporation) Thiokol actually rented a small second-story walk-up office in Marshall, Texas as an "office" for the DISC, reporting on its 1981 DISC federal tax return rental expense of $1,350 and salary expense of $1,262. The salary expense reimbursed an affiliated company for the service of one of its employees, otherwise employed nearby, who occasionally would go to the "DISC" office and transfer numbers pertaining to the DISC from one book to another. The tax manager for Thiokol's parent company testified on deposition introduced into the record before the Maryland Tax Court that this was done solely for the purpose of inexpensive state tax avoidance, e.g. "We wanted to operate the DISC in a state that did not have a corporate income tax." In the proceedings below Thiokol did not argue that this device entitled them to treatment by Maryland different from the other two Petitioners.

In the proceedings below none of the Petitioners ever claimed that they were not engaged in a unitary business with their parent companies. No Petitioner challenged the fairness of the apportionment formula applied against DISC income, which determined Maryland taxable income by a 3-factor apportionment formula composed of the parent company's Maryland property and payroll, and a zero sales factor that accounted for the non-Maryland destination of goods exported through the DISC.[1] The Petitioners effectively conceded below (Brief of Appellees, p. 25; Pet. for Certiorari to the Maryland Court of Appeals, p. 9-11) that Maryland has constitutional authority (i.e. nexus) to tax a "Maryland" DISC; yet they were never able to suggest in any Court below what is it that makes a DISC a "Maryland" DISC when the DISC will not have employees or property in any state. Finally, the Petitioners did not contend below that the tax herein was forbidden or pre-empted by federal statute, or by the Import-Export clause of the Constitution.

The Maryland Tax Court and the Circuit Court for Baltimore City rejected the Comptroller's contentions that these companies were taxable by Maryland. The Court of Special Appeals reversed the lower courts and sustained the Comptroller's assessments against the Petitioners, holding that the Maryland legislature clearly intended to tax DISC income, and that such tax was not forbidden by the Constitution. The Maryland Court of Appeals denied certiorari, finding that further review was neither desirable nor in the public interest, Md. Code Ann., Courts & Judicial Proc. Art. § 12-203.

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[1] This type of apportionment formula for DISCs was approved by both the Maryland Tax Court and the Court of Special Appeals in *Ward Europa, Inc. v. Comptroller*, 66 Md. App. 332, 503 A.2d 1371 (Md. Ct. Special App. 1986). Maryland uses the destination rule to allocate sales receipts for the apportionment formula, see Code of Maryland Regulations, Title 3, 03.04.03.08C.

ARGUMENT

THE PECULIAR AND CLOSED NATURE OF DISCS MAKE THIS CASE PARTICULARLY INAPPROPRIATE FOR CERTIORARI JURISDICTION

Petitioners concede that income of a DISC is fully taxable under a fair apportionment formula if the tax is levied upon the parent company that owns the DISC and performs all DISC activity. Petition for Certiorari, p. 2. One treatise has noted that Maryland's method of taxing the DISC directly on its income achieves substantially the same result, see *State Taxation, V I, Corporate Income and Franchise Taxes*, Jerome R. Hellerstein (1989 Cum. Supp., (Jerome R. & Walter Hellerstein) ¶ 9.19 [3], p. S537).

Such concession is not surprising; a claim that a state had no nexus to tax DISC income was dismissed on appeal to this Court as not raising a substantial federal question, see *Westinghouse Elect. Corp. v. Tully*, 434 N.E. 2d 1044 (N.Y., 1982), 459 U.S. 1144 (1983), rev'd on other grounds, 466 U.S. 388 (1984).[2] Petitioners therefore seek review so as to procure a ruling from this Court that States may not do directly what Petitioners concede may be done indirectly; that due process requires a particular tax return format in order to achieve nexus. Such review would be an inappropriate exercise of this Court's discretionary jurisdiction.

Certiorari jurisdiction is only to be granted in cases of conflicting decisions in the lower courts, matters of

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[2] Petitioners contend (Petition for Certiorari, p. 16) that this Court indicated a contrary view in *Westinghouse* at 466 U.S. 394, fn. 4. If the entire footnote and accompanying text are considered, it is clear that this Court was not in fn. 4 indicating a view on a constitutional issue not before it, but instead describing the New York statutory history. In any event the DISC at issue in *Westinghouse* was, notwithstanding a fear by New York of "formation . . . outside the State", *id.*, incorporated in Delaware and not in New York.

public importance, or direct conflict with decisions of this Court, Rule 10. None of these standards are met here. The Maryland Courts have merely applied applicable precedent of this Court to find, on the facts of this case, that interlocking activities of unitary affiliates are sufficient to create nexus.

In this case Petitioners assert that the opinion below allows nexus merely because of a unitary relationship, Pet. for Certiorari, p. 9; Respondent contends that nexus over the DISC is established by the specific facts in the record that underlie the unitary relationship, i.e., the activities conducted by the parent company in Maryland "on behalf of the [DISC]", 82 Md. App. 437, 572 A. 2d 567. It is most important to note however, that review of this case will not be particularly helpful in determining when nexus exists over particular subsidiary corporations because of unitary ties; and that there is no evidence from the Petition that this intellectual question is anything more than hypothetical.

This case involved DISCs—peculiar tax shelter entities whose tax benefits under federal law were largely repealed by the Revenue Act of 1984, see Bittker, *Taxation of Income, Estates and Gifts*, ¶ 68.2.5; (1990 Supp.) [3] DISCs are inherently peculiar because they permit the shifting of income from one entity to another without the recipient (or DISC) conducting any activity to earn that income—a practice normally prohibited for ordinary business subsidiaries by I.R.C. § 482. Since the DISC must have its parent act on its behalf it is questionable whether the inter-corporate connections and activities produced thereby (and which create nexus in this case) have relevance to other "real" unitary subsidiaries and the tax

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[3] Their replacement as shelter entities for export profits under federal law are foreign sales corporations (FSCs), *Bittker, supra,* ¶ 68.7.2 (1990 Supp.). FSCs (unlike DISCs) are required to have a bona fide overseas presence. Maryland does not view a FSC as an alter ego of its parent, and has no case pending against any FSC.

issues they produce. Maryland, in fact, does not assert nexus over all unitary corporate affiliates because of the physical presence in Maryland of one of them; it instead makes determinations on a case by case basis because of the facts of each, see *Wright & Miller*, Federal Practice & Procedure, V. 4, § 1069, n. 29-31.

The effect of this case is also limited by the interplay between the Commerce Clause and the Due Process Clause. These two constitutional provisions require fair apportionment of DISC income, see *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1974); *Mobil Oil Corp. v. Commissioner*, 445 U.S. 425 (1980). This limits the actual tax on DISC income in the 16 non-combined reporting states to the actual presence of the parent company in these states. If large amounts of employees and property are present, the tax may be great; if such presence is small the tax will be small as well.

Consistent with this operational effect the Maryland Comptroller has only 14 DISC cases pending, all in the Maryland Tax Court. Almost all of these taxpayers have agreed to be bound by the ultimate decision in this case, and the majority of cases do not exceed $50,000 in amount.

The effect of the decision below is further limited by the concededly lawful taxation of DISC income on a combined basis with the parent company, and the fact that a majority of states do so. Since the 16 states that do not do so could not retroactively change their tax return format, the utility of a precedent requiring them to adapt a particular type of tax return is questionable—since it could not be ruled upon in such a case how such requirement would apply to non-DISC subsidiaries.

The Petition is based on an erroneous premise. It contends that the decision below rested nexus solely on unitary ties, Petition for Certiorari, p. 9. This was not in fact the reasoning of the Court of Special Appeals. That

Court instead held that nexus exists when: (1) the parent company has an actual presence in the taxing state; (2) it is unitary with a subsidiary that performs *no* activities on its own; (3) events directly connected to the income to be taxed occur in the State, i.e., export production; (4) the parent company acts "on behalf of" the DISC. The decision does not break new ground; it is consistent with and supported by the modern cases in this Court that establish nexus not only by the physical presence in the taxing state of employees or property of the company to be taxed, but also by activities undertaken "on behalf of" the company to be taxed.

The actual activities within a taxing state that must take place for tax jurisdiction to be conferred can be minimal, see *Northwestern States Portland Cement Co. v. Minnesota* and *Williams v. Stockton Valves & Fittings, Inc.*, 358 U.S. 450 (1959); *Standard Pressed Steel Co. v. Washington Dept. of Rev.*, 419 U.S. 560 (1975). The modern statement of the nexus rule by this Court is as follows: "For a State to tax income generated in interstate commerce the Due Process Clause of the Fourteenth Amendment imposes two requirements: a 'minimal *connection*' between the interstate *activities* and the taxing state, and a rational relationship between the income attributed to the State and the intrastate *values* of the enterprise." *Mobil Oil Corp. v. Commissioner*, 445 U.S. 425 (1980) at 436-437. (emphasis added)

The use in *Mobil* of general words such as "connection", "activities" or "values" was not accidental; this Court has repeatedly pointed out that nexus determinations among interlocking corporations are to be made on the basis of real, underlying events, and not the corporate formalities suggested by the Petition. Thus, nexus is not achieved merely because a dividend has been received, see *Asarco v. Idaho*, 458 U.S. 307 (1982); conversely this Court has sustained a tax on all of the income of a foreign subsidiary engaged in a unitary business, even though no divi-

dend was paid, see *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159 (1983).

The Maryland Court of Special Appeals followed these principles to the letter. It held that the very nature of a DISC, with its lack of employees, property or tangible, bona fide existence *anywhere*, meant that the DISC could and should be viewed as conducting business in Maryland because of Maryland "activities" of its parent that were demonstrated in the record, that related to the income of the DISC, and provided, as expressed in *Mobil*, the "minimal connection" necessary. The Court of Special Appeals expressed this as follows: "Nexus, therefore, cannot be found wanting for lack of employees or property where, as here, business is *conducted in this state on behalf of* the phantom corporation by its unitary corporate affiliates." 82 Md. App. 437, 572 A. 2d 567. (emphasis added). It is not merely that the DISC is unitary with its parent that gives jurisdiction; it is that the parent is effectively the Maryland agent of the DISC, and acts "in this state on [its] behalf," as agents typically do.

This holding is supported by a long line of precedent holding that nexus to tax a company without employees or property in the taxing state can be achieved through activities undertaken on the company's behalf by others, see *Williams v. Stockton Valves & Fittings, Inc., supra*; *Scripto v. Carlson*, 362 U.S. 207 (1960); *People v. United National Life Insurance Co.*, 66 Cal. 2d 577, 427 P. 2d 199, 58 Cal. Rptr. 599, appeal dism'd for want of a substantial federal question, 389 U.S. 330 (1967); *Ministers Life & Casualty Union v. Haase*, 30 Wis. 2d 339, 141 N.W. 2d 287, appeal dism'd for want of a substantial federal question, 385 U.S. 205 (1966); *Illinois Commercial Mens Assn. v. State Bd. of Equalization*, 34 Cal. 3d 839, 671 P. 2d 349, 196 Cal. Rptr. 198 (1983) appeal dism'd, 466 U.S. 933 (1984); *Readers Digest Assn. v. Mahin*, 44 Ill. 2d 354, 255 N.E. 2d 458, appeal dism'd,

399 U.S. 919 (1970); *Comptroller v. Atlantic Supply, Inc.*, 294 Md. 213, 448 A. 2d 955 (1982).

This precedent amply supports nexus over a DISC under the complete control of its parent where the parent conducts all of the activities relating to the DISC, and both export production and activities relating to export production take place in the taxing state. That companies may be taxed because of activities undertaken in the taxing state "on [their] behalf" is so well recognized as to have been afforded a long-standing federal safe harbor from such nexus and tax, see P.L. 86-272, 73 Stat. 555, 15 U.S.C. § 381 (1959);[4] the result below therefore merely implements the well recognized principle that interlocking corporations can, and sometimes do, act on behalf of one another, see *Hellerstein, supra*, 1989 Cum. Supp. § 6.7 [3], p. S111.

This Court wisely limits its cases to real disputes because it recognizes that the best law is made in the context of concrete facts. The Petition offers no evidence in the form of state tax practice or actual recent state tax cases that it is necessary or wise to incorporate into the Constitution a particular tax reporting method; it fails to recognize that it would be doubly unwise to do so in the peculiar context of an unusual corporate device whose existence is rapidly fading into history.

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[4] This statute was enacted in response to this Court's decision in *Northwestern States, supra*. It prohibits a State tax if companies limit both their activities and those undertaken on their behalf. Petitioners do not contend that they come within its terms.

CONCLUSION

For the foregoing reasons, the Petition should be denied.

Respectfully submitted,

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